

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition :  
of :  
**FRANKLIN C. LEWIS** : DETERMINATION  
for Redetermination of a Deficiency or for Refund : DTA NO. 827791  
of New York State Personal Income Tax under :  
Article 22 of the Tax Law for the Years 2009, :  
2010 and 2011. :  
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Petitioner, Franklin C. Lewis, filed a petition for redetermination of a deficiency or for refund of New York State personal income tax under article 22 of the Tax Law for the years 2009, 2010 and 2011.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, in Albany, New York, on August 29, 2018, at 10:30 A.M., with all briefs to be submitted by December 21, 2018. Petitioner appeared by Bond, Schoeneck & King (Jennifer M. Boll, Esq., of counsel). The Division of Taxation appeared by Amanda Hiller, Esq. (Michele W. Milavec, Esq., and Michelle M. Helm, Esq., of counsel).

***ISSUES***

I. Whether the Division of Taxation properly determined that a nonresident individual's gain received on the sale of the stock he owned in an electing subchapter S New York domestic corporation was required to be included in that individual's New York source income, to the extent recognized for federal income tax purposes and in accordance with the S corporation's business allocation percentage, in 2009, the year of sale, and in 2010 and 2011, from installment

payment obligations resulting therefrom, per Internal Revenue Code § 453 (h) (1) (A), where the sale transaction was subject to the deemed asset sale election provisions of Internal Revenue Code § 338 (h) (10).

II. If so, whether petitioner has nonetheless established that the proper New York business allocation percentage of the S corporation was zero in the year of sale (2009), such that none of the income in question is allocable to, or taxable by, New York.

III. Whether petitioner has established grounds warranting abatement of the penalties asserted pursuant to Tax Law § 685 (a) (1) for failing to have filed tax returns for the years 2010 and 2011.

#### ***FINDINGS OF FACT***

1. Petitioner, Franklin C. Lewis, was a nonresident of New York during the years 2009, 2010 and 2011. Prior to July 31, 2009, petitioner owned 50% of the shares of Energy Service Providers, Inc. (ESPI), a New York domestic corporation, incorporated on October 21, 2002, that had in place a valid election to be taxed under subchapter S of the Internal Revenue Code (IRC) for federal and New York state income tax purposes. Generally, an S corporation does not pay income tax at the corporate level, but passes its income and deductions through to its shareholders, who report the same on their personal tax returns.

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<sup>1</sup> The parties jointly submitted a stipulation of facts setting forth ten, separately numbered and agreed to facts. These stipulated facts are set forth as part of the findings of fact herein. The Division of Taxation also requested that the statement of facts set forth in its brief be included herein as findings of fact, per State Administrative Procedure Act § 307.1 and 20 NYCRR 3000.15 (d) (6). This is essentially a request to address and rule on the statement of facts as proposed findings of fact (*see id*). The Division's statement of facts is not set forth in the format of individual proposed findings of fact (i.e., set forth in separately numbered format), amenable to individual rulings thereon. Hence, the statement of facts will not be addressed or ruled on in that fashion. Nonetheless, careful review of the statement of facts reveals the same to be accurate and supported by the record, and accordingly, the same have been substantially included in the findings of fact set forth herein.

2. ESPI entered into a Securities Purchase Agreement (Purchase Agreement) with U.S. Gas & Electric, Inc. (USGI), dated July 31, 2009, pursuant to which each ESPI shareholder, including petitioner, and USGI “wished to sell the Purchased Shares to Buyer, and Buyer wished to purchase the Purchased Shares from the Sellers, on the terms and subject to the conditions of this Agreement.”<sup>2</sup> Under the terms of the Purchase Agreement, the sellers, including petitioner, and the buyer, negotiated and agreed to make an IRC § 338 (h) (10) election. Accordingly, though the transaction was a sale of stock, the effect of the jointly made IRC § 338 (h) (10) election was that ESPI, as seller, was deemed to have sold all of its assets in a taxable transaction, and USGI, as buyer, was treated as having purchased the assets, so as to receive a step-up in the basis of the assets. Generally speaking, such an election at the federal level may be advantageous to the purchaser due to the stepped-up basis of the assets deemed to have been purchased (for future depreciation and/or amortization purposes). The purchaser, in short, gets the convenience of a stock purchase with the tax benefits of an asset purchase. At the same time, such an election may be disadvantageous to the seller, due to possible higher federal tax liability as the result of being taxed at a higher rate on gain from the sale of assets than would be the case on gain from the sale of stock. Since New York’s income tax is a federal “conformity based” system, such an election can carry with it New York state tax implications for both residents and nonresidents.

3. Prior to closing on the ESPI sale to USGI, as described above, and prior to agreeing to make the IRC § 338 (h) (10) election, petitioner consulted with his tax accountant, Alan Eckstein, CPA, and others, regarding the tax consequences of the transaction, including

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<sup>2</sup> Article I, section 2.2 (b) of the Purchase Agreement specifies that, while the actual closing date was July 31, 2009, the parties intend that for financial and tax reporting purposes, the closing will be deemed to have occurred on June 30, 2009.

specifically whether the IRC § 338 (h) (10) deemed asset sale election would subject petitioner's sale proceeds to New York income tax. In response, petitioner was advised that at the time of the sale (i.e., in 2009), a stock sale that was a deemed sale of assets pursuant to an IRC § 338 (h) (10) election did not change the nature of the transaction for New York income tax purposes.

Specifically, petitioner was advised that under a then recently-issued Tax Appeals Tribunal (Tribunal) decision (*Matter of Baum*, Tax Appeals Tribunal, February 12, 2009), a transaction such as the proposed ESPI to USGI sale would be treated, for New York purposes, as the sale of an intangible, i.e., stock, notwithstanding the deemed asset sale treatment for federal tax purposes under the IRC § 338 (h) (10) election, leaving a nonresident such as petitioner not subject to New York tax thereon. This advice was specifically conveyed via an email from Mr. Eckstein to petitioner, in which Mr. Eckstein referenced the Tribunal's decision in *Baum*.

4. After many months of negotiating with the buyer (USGI), and upon the foregoing advice that he would not be subject to New York tax on the gain from the transaction, petitioner agreed to forego continued negotiations seeking an increased purchase price, or an indemnity (hold harmless) provision, from the purchaser for any additional taxes arising as the result of the IRC § 338 (h) (10) election.<sup>3</sup>

\_\_\_\_ 5. At no time in 2009 did ESPI liquidate or distribute assets to petitioner. Among other consideration for the sale transaction, petitioner received an installment obligation and a cash payment. Petitioner's installment obligation qualified for treatment under IRC § 453 (h) (1), permitting recognition of gain periodically upon (future) receipt of payments on the installment obligation.

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<sup>3</sup> An election under IRC § 338 (h) (10) is a joint election that must be made by both the purchaser and the seller.

\_\_\_\_\_ 6. ESPI filed a U.S. income tax return for an S corporation (federal form 1120-S), and a corresponding New York S corporation franchise tax return (form CT-3-S), for the short period spanning January 1, 2009 through June 30, 2009, reporting a capital gain, on an installment basis, in the amount of \$6,148,266.00. On its form CT-3-S for the foregoing short period, filed on April 14, 2010, ESPI reported a 100% New York state business allocation percentage (BAP). ESPI did not include a BAP schedule with the filing of this return. Since its incorporation in New York on October 21, 2002, 100% of ESPI's receipts had been apportioned to New York state in its franchise tax filings.

7. Page one of form CT-3-S asks, at line G thereof, "Did the S Corporation make an IRS section 338 or 453 election?" On the form CT-3-S filed by ESPI for the short period during which the sale in question occurred, ESPI checked the "No" box at line G in response to the foregoing question. ESPI's form CT-3-S for this period, as well as petitioner's form IT-203 for the year 2009 (*see* finding of fact 10), were prepared by the firm by whom Mr. Eckstein was then employed, and he reviewed such returns before they were signed and filed.

8. On August 11, 2010, Tax Law § 632 (a) (2) was amended to specifically state that a non-resident S corporation shareholder must treat the sale of stock subject to an election under IRC § 338 (h) (10) as the sale of assets and apportion the proceeds thereof to New York in accordance with the S corporation's BAP, without consideration of any deemed liquidation (2010 Amendments).

9. On August 31, 2010, the Division issued a memorandum providing public notice and guidance with respect to the 2010 Amendments (*see* TSB-M-10 [10] I). This memorandum noted that the amendments were retroactive, and specifically were effective for tax years

beginning on or after January 1, 2007 and any other taxable year in which the period of limitations on assessment remained open.

10. On October 14, 2010, petitioner filed his 2009 New York State nonresident and part-year resident income tax return (form IT-203), reporting thereon his share of the foregoing capital gain at line seven in both the federal and New York columns, thus indicating that the gain was reportable to New York. By virtue of ESPI's 100% BAP, petitioner reported 100% of his share of the gain arising from the Purchase Agreement as New York source income. However, on the same return, petitioner reported a New York subtraction modification removing 100% of the foregoing allocated capital gain resulting from the deemed asset sale of ESPI from his New York adjusted gross income (AGI).

11. For the years 2010 and 2011, petitioner received income from the installment payment obligation arising from the Purchase Agreement, and governed under IRC § 453 (h) (1) (A). Petitioner did not file a form IT-203 for either of these years, and did not allocate any of the income received under the installment payment obligation to New York, per Tax Law § 632 (a) (2).

12. Both petitioner and Mr. Eckstein testified at hearing that they did not recall receiving any communications from the Division of Taxation (Division) regarding whether or not taxpayers should rely on the Tribunal's decision in *Baum*. Mr. Eckstein testified that he could not recall, but did not think he was aware of the Division's issuance of any public guidance or notice, including TSB-M-10 (10) I, prior to the October 14, 2010 filing of petitioner's 2009 return.

13. Petitioner did not file an amended return for the year 2009, and did not file any New York State return for either 2010 or 2011. Ultimately, and as a consequence of his reporting

position, petitioner did not pay any New York personal income tax on the proceeds arising from the ESPI to USGI sale transaction.

14. The Division conducted a field audit of the final return form CT-3-S filed for ESPI for the short period spanning January 1, 2009 through June 30, 2009, and the corresponding reporting of that S corporation's income by its shareholders, including petitioner. The Division's review of returns filed by ESPI, and by petitioner, together with the documentation provided on audit, resulted in a determination that the transaction was properly a deemed asset sale, per IRC § 338 (h) (10), with the proceeds from such transaction properly treated as resulting from an asset sale, and thus constituting New York source income to the extent of ESPI's BAP. For 2009, the Division disallowed petitioner's claimed subtraction modification removing the capital gain income from the deemed asset sale from his return since Tax Law § 612 (c) does not include or provide a subtraction modification for such income. In turn, such entire gain was treated as New York source income, allocable as based on ESPI's reported BAP of 100%, and was subjected to New York tax. For 2010 and 2011, the Division determined that petitioner was obligated to file and report the installment payments arising from the deemed asset sale as New York source income, per Tax Law § 601 (e), with the same allocable to New York based on ESPI's reported BAP of 100%, pursuant to Tax Law § 632 (a) (2), and properly subject to New York tax.

15. On May 30, 2013, the Division issued to petitioner a notice of deficiency (assessment ID L-039487251), asserting additional New York state personal income tax due for the years 2009, 2010 and 2011, in the aggregate amount of \$810,815.00, plus interest, and penalty under Tax Law § 685 (a) (1) for failure to have filed a return for either of the years 2010 and 2011.

16. At hearing, petitioner introduced the testimony of James Cahill, a professional engineer with many years of direct experience in the field of public utilities, energy provision and

energy efficiency. Mr. Cahill served as ESPI's vice president for the three year period prior to the sale of ESPI that is at issue in this matter. Mr. Cahill explained that in the late 1990s, the energy industry, which had previously been a public utility-based monopoly including generation, transmission, delivery and sale of energy to end-user customers, was deregulated and restructured such that consumers could select who would supply their energy.<sup>4</sup> Under deregulation and restructuring, the public utilities would continue to transmit and deliver electricity to end-users, via their transmission network (towers, poles, wires, meters, etc.), maintain such distribution network (grid), and be paid for doing so. However, in order to promote energy price competition, reliability, and efficiency, to the benefit of both end-users and the energy industry in general, entities known as energy services companies (ESCOs) were created as new competitive suppliers in the marketplace. At the same time, and in conjunction with the conversion to deregulation, various price-reduction and other incentives became available to end-users who switched to competitive suppliers.<sup>5</sup>

17. Initially, most ESCOs were large, utility-owned (second tier) companies, with power generation capabilities, who owned the electricity, had significant finance availability, and could advise their large customers to undertake large scale energy efficiency upgrades at their facilities, and pay for such upgrades through their bills. Mr. Cahill noted, however, that in connection with deregulation, and the accompanying changes in the manner in which public utilities were to do business, there was a need for smaller companies who could "facilitate the educational

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<sup>4</sup> Deregulation impacted both gas and electric energy. Since ESPI was involved only with electrical energy, this determination confines itself only to that type of energy.

<sup>5</sup> Among the incentives referenced by Mr. Cahill that became available in conjunction with deregulation, were the reduction or elimination of (state and/or local) sales taxes and gross receipts taxes, certain per kilowatt hour reductions in the cost of electricity, and additional rebates based on efficiency upgrades.

knowledge to the customer so that the customer would be able to benefit from the various programs that were now being offered.” Mr. Cahill distinguished smaller ESCOs, such as ESPI, from the larger ESCOs described above, as follows:

“Well, they would call us ‘suppliers,’ but we facilitated the transaction; we would inform a customer, do you know that your utility says if you switch to a competitive supplier, you’re going to get a benefit of a reduction in sales tax – well, actually, it was a waiver, a complete waiver of sales tax, and a waiver of the gross receipt[s] taxes, and they gave the customers an incentive of 4 mils; I believe it was .004 cent discount off of their usage in the electricity bill. So they encouraged, one, customers to switch to outside or different ways to get their electricity, and then they encouraged the energy service providers, and they created an incentive[s] for us to come in; one was that offset in the taxes, because we weren’t – like any company, we would have passed it through if the customer had to pay sales tax on the goods. And if the customers had to pay gross receipts taxes, then the prices would have probably changed to the customers, as well.

So that alleviation of taxes created this giant profit center for new companies, as well as it created an opportunity of savings for the customers.”

18. Mr. Cahill further distinguished ESPI from the larger ESCOs, including those who had been divested (or “unbundled”) from utility companies as second tier companies, by noting that the latter, larger ESCOs could “wield” power, by virtue of their size and financial wherewithal, so as to negotiate with power generators to purchase blocks of power in advance at a more favorable “day-ahead” price, from which a fixed price product could then be offered to customers. By contrast, ESPI and other smaller ESCOs without the clout to do so, obtained electricity for their customers directly through the New York Independent System Operator (NYISO) energy “pool,” and “passed through the charges.”

19. Mr. Cahill described ESPI as a service provider that facilitated transactions between customers and public utility companies by assisting customers, most of whom were located in New York, in taking advantage of governmental incentives that had become available in

connection with deregulation of the utility industry. He stated that EPSI employees would, with the “blessing” or approval of the utilities, contact potential customers in “optimal areas,” meaning customers who were receiving their electricity from such public utilities (i.e., captive customers) in areas where various benefits and incentives associated with deregulation were offered. In turn, and using ESPI’s proprietary software, ESPI’s employees would input and analyze, or “scrape,” utility data regarding such utility companies’ customers’ electricity usage, in connection with the potential impact of applying the various incentives stemming from deregulation, so as to determine how, and to what extent, such customers could reduce their electrical bills.

20. ESPI’s employees contacted potential customers via telephone from a call center located in Pittsfield, Massachusetts, advised that the potential customers’ public utility had given its approval for ESPI to contact them, and explained that ESPI could help save money on the potential customers’ energy bills. The potential customers would provide their account numbers to ESPI’s employees, who in turn would analyze the potential customers’ bills, as above, and advise over the phone as to the potential savings. ESPI’s aim was to sign up such public utility customers as its own customers, based on the reduced energy price it could offer. ESPI’s price for electricity was described as a “blended” per kilowatt hour price, calculated based on ESPI’s cost to purchase electricity from NYISO, in combination with utilizing certain of the available price reduction incentives described above, to arrive at a price that was less than the “captive” price charged by the public utility, but which still allowed ESPI to make a profit.

21. To assure it could provide power for its customers, ESPI would advise NYISO of the estimated amount of electricity ESPI’s customers would use, so that the same would be “set aside” as available. Electricity was delivered to ESPI’s customers by the public utility for the

particular customer's area through the power transmission and distribution grid. The public utilities were obligated to maintain the transmission and distribution grid (e.g., repair downed power lines, broken meters, etc.) so as to assure reliable delivery of power. Each ESPI customer was billed for the amount of electricity used, as metered, and at the price determined under ESPI's contract with each customer.

22. ESPI's customers did not pay ESPI directly. Instead, under the "one-bill" system, the delivering public utility would bill each customer based on their metered consumption of electricity, and would remit the amount due ESPI after collecting payment from the customer on behalf of ESPI. ESPI would, in turn, pay NYISO based on the metered ("trued-up") amount of power consumed by its customers, with the differential (less ESPI's operating costs) representing ESPI's profit.<sup>6</sup> In consequence, whereas consumers who elected to purchase their electricity directly from the public utilities would pay the public utility's captive customer price, consumers who purchased from ESCOs, such as ESPI, could receive a lower price per kilowatt hour for their electricity based upon the particular blend of the tax benefits, rebates, discounts, and other incentives available from the various competing ESCOs. Mr. Cahill described the foregoing as follows:

"[ESPI] took [the state and local sales tax] reductions, as well as the .004 reduction. And then, because we were facilitating the transaction, we then offered back to the customer the ability to reduce the rate based on those – so their bill, based on the inclusion of taxes and what they were paying before was X. But because they said, please go with Energy Service Providers, we're going to eliminate the [sales taxes] for you and we're going to reduce your bill by .004,

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<sup>6</sup> In his testimony, Mr. Cahill stopped short of affirmatively stating that ESPI was responsible to pay for the electricity used by a customer in the event that customer did not pay their bill. Rather, he noted the obligation of the delivery utility to bill and collect from the customer under the one-bill system, and the authority of the utility, as opposed to ESPI, to suspend or terminate power delivery in the event of customer non-payment. Nonetheless, the tenor of the testimony, together with contract documents in the record concerning electricity purchases by ESPI from NYISO, support the finding that if a customer didn't pay for their electricity, ESPI was still required to pay NYISO.

then we were allowed to go in there and we – you know, we'd have transactional fees in there, but we gave back a blended reduced price for the customer. So it was definitely lower than they were paying prior to the relationship [with ESPI].”

23. Mr. Cahill stated in his testimony that ESPI's employees carried out the foregoing activities via telephone and computer contact from ESPI's call center in Pittsfield, Massachusetts. He also stated his opinion that ESPI did not take physical possession of a tangible asset, per se, but rather that “it's all done through via meters and electronic transfer of data.”

24. “ESPI's Business” is defined in Article VIII of its Purchase Agreement with USGI as having “the meaning set forth in the Recitals.” Item C of the Purchase Agreement Recitals states that ESPI is “in the business of providing energy to commercial and residential customers in certain states in which the energy market has been deregulated (the ‘ESPI Business’).” The Purchase Agreement provides, at section 2.11 (c), that ESPI holds New York Retail Licenses allowing ESPI to “sell or market electric energy at retail in the State of New York.” Section 2.22 (b) of the Purchase Agreement states that there are no matters outstanding that would materially impact ESPI's “ability to transact business as an electric supplier in any jurisdiction.” On its federal forms 1120-S, ESPI reported its “business activity code number” as “221100,” corresponding generally to “Utilities,” and code-specifically to “power generation, transmission and distribution.” On its federal and New York corporation tax returns, ESPI consistently reported its “principal business activity” as “energy provider,” and its “product or service” as “energy.”

25. As noted, since its incorporation in 2002, 100% of ESPI's receipts have been apportioned to New York State for purposes of computing and reporting its BAP on its New York State S corporation franchise tax filings. In fact, ESPI reported a 100% BAP on such

filings for all of the years spanning 2002 through its sale in July 2009, with the exception only of the year 2006, when (as an apparent consequence of “BAP factor weighting”) it reported a 60% BAP.<sup>7</sup> By contrast, none of ESPI’s receipts were apportioned to the Commonwealth of Massachusetts during any of the years 2006 through 2009.

### ***CONCLUSIONS OF LAW***

A. When the Division issues a notice of deficiency to a taxpayer, a presumption of correctness attaches to the notice, and the burden of proof is on the taxpayer to demonstrate, by clear and convincing evidence, that the asserted deficiency is erroneous (*see Matter of O’Reilly*, Tax Appeals Tribunal, May 17, 2004; *see also Matter of Leogrande v Tax Appeals Tribunal*, 187 AD2d 768 [3d Dept 1992], *lv denied* 81 NY2d 704 [1993]; *Matter of Tivolacci v State Tax Commn.*, 77 AD2d 759 [3d Dept 1980]; Tax Law § 689 [e]). In short, petitioner carries the burden of proof to overcome the tax asserted as due in this proceeding (Tax Law § 689 [e]).

B. Petitioner advances two arguments in support of canceling the deficiency at issue. First, petitioner argues that retroactively imposing liability against him under the 2010 Amendments, in light of the particular circumstances concerning the ESPI to USGI sale transaction, constitutes an as applied violation of the Due Process Clauses of the United States and New York constitutions (the due process issue). Petitioner specifically maintains that he fully and reasonably relied upon the advice and explanation of his tax accountant, given with particular reference to the Tribunal’s decision in *Baum*, that the gain received by a non-resident of New York who sold a corporation via a stock sale would not constitute New York source income subject to tax, notwithstanding that the parties to the sale made an IRC § 338 (h) (10)

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<sup>7</sup> Beginning in 2007, New York State required the allocation of corporate income on the basis of a BAP consisting of a single, receipts only, apportionment factor, as opposed to the inclusion of additional property and payroll BAP apportionment factors, as had been the case in earlier years.

election to treat the transaction as a deemed asset sale. Petitioner recognizes that challenges by other, similarly situated, individuals who adopted the same filing position, have been rejected based upon the 2010 Amendments to Tax Law § 632 (a) (2) (*see* L 2010, c 57, Parts B, C), and the retroactive applicability specified therein (*see* L 2010, c 57, Part B, § 1). However, petitioner argues that since his transaction occurred after the *Baum* decision was issued, his reliance-based due process argument is stronger than the arguments presented in the other cases.

Secondly, petitioner argues that even if imposition of the tax at issue is upheld against the foregoing due process challenge, his gain from the sale of ESPI is not subject to New York State tax in any event because ESPI's proper New York BAP should be zero. On this score, petitioner maintains that ESPI did not provide any "tangible personal property or electricity" to its customers, but rather that it "facilitated transactions and consulted with customers regarding the utility providers." As a consequence, petitioner argues that ESPI's receipts were realized from providing services, and that all of the functions performed in carrying out such services occurred outside of New York State from a call center in Pittsfield, Massachusetts. Petitioner therefore maintains that none of ESPI's receipts should be apportioned to New York. In turn, since ESPI's New York's BAP during the first year in issue (2009) was calculated based upon a single-factor, receipts-only apportionment formula (*see* Tax Law § 210 [3]), ESPI's BAP should properly be zero, and since the gain from the sale of ESPI is apportioned to New York in accordance with ESPI's BAP during the year of the sale (*see* Tax Law § 632 [a] [2]), it follows that none of the gain from the sale, including specifically petitioner's share thereof, may be subjected to New York tax. Each of these alternative arguments will be addressed in turn.

***IRC § 338 (h) (10) Deemed Asset Sales, Tax Law § 632 (a) (2), Retroactivity, and Reliance***

C. In resolving the due process issue, it will be helpful to review the previously decided cases involving a nonresident's treatment of the gain resulting from a transaction involving the sale of stock in a New York S corporation (or an S corporation otherwise having tax nexus with New York), where the parties to the sale jointly elected to have the transaction treated as the sale of the S corporation's assets (a "deemed" asset sale) under IRC § 338 (h) (10), including instances where the gain was payable in future years under installment obligations subject to IRC § 453 (h) (1) (A).

D. In *Caprio v New York State Dep't. of Taxation & Fin.* (25 NY3d 744 [2015], *rearg denied* 26 NY3d 955 [2015]), Philip Caprio, a nonresident of New York (and others), sold all of the shares in an S corporation that earned nearly 50% of its income in New York. The parties to this March 1, 2007 sale jointly elected § 338 (h) (10) deemed asset sale treatment, and the sale was structured such that the purchase price was to be paid in installments under promissory notes, whereby the seller would therefore report income from the sale in future years when such was income was received, per IRC § 453 (h) (1) (A), rather than in the year in which the notes representing the installment obligations were received by Mr. Caprio. Mr. Caprio reported no income or gain from the sale for New York purposes, upon the position that the same should be treated as proceeds of the sale of an intangible, i.e., stock, as opposed to the sale of assets, notwithstanding the deemed asset sale result afforded under the federal § 338 (h) (10) election.

E. In *Matter of Luizza* (Tax Appeals Tribunal, March 29, 2016), Jeffrey Luizza, a nonresident of New York, sold all of his shares of an S corporation that did business partially in New York. This March 18, 2008 sale was initially structured to be a sale of stock. However, in subsequent negotiations, the buyer requested Mr. Luizza to join in an election to treat the

transaction as a deemed asset sale under IRC § 338 (h) (10). Mr. Luizza, concerned about potential negative New York tax implications, proposed the inclusion of a “hold-harmless” indemnification clause reading “Buyer shall reimburse seller for all costs and negative tax consequences of the 338 (h) (10) election.” In response, the buyers preferred to address the tax cost of the § 338 (h) (10) election, if any, “up front.” To determine the potential for additional taxes, Mr. Luizza and his long time accountants researched the tax implications of the election, and concluded, based on their view of the law applicable at the time of the sale, that there would be no additional New York tax consequences to Mr. Luizza resulting from the § 338 (h) (10) election. As a result of this advice, Mr. Luizza, like petitioner herein, did not require the buyer to increase the purchase price or to provide indemnity for any additional taxes resulting from the election.<sup>8</sup> As above, no income or gain from the sale was reported for New York purposes, upon the position that the same should be treated as proceeds of the sale of an intangible, i.e., stock, as opposed to the sale of assets, notwithstanding the deemed asset sale result afforded under the federal § 338 (h) (10) election.

F. In *Matter of Baum* (Tax Appeals Tribunal, February 12, 2009), the Tax Appeals Tribunal held that, notwithstanding an election under the provisions of IRC § 338 (h) (10), the substance of transactions such as those described above remained a sale of stock, and that since gains from the sale of stock are not New York source income to a nonresident, such gains were not required to be included in the New York entire net income of the subchapter S corporation, or to be passed through to the shareholders thereof. Consistently, in *Matter of Mintz* (Division of

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<sup>8</sup> In the ensuing litigation (*see* conclusion of law L), Mr. Luizza and the Division agreed and stipulated to the fact that, upon the advice provided by his accountants, Mr. Luizza “reasonably relied on the New York law applicable at the time of the sale when he agreed not to require the Buyer to increase the purchase price nor to provide indemnity for any additional taxes arising as a result of the election” (*see Matter of Luizza*).

Tax Appeals, June 4, 2009), an administrative law judge concluded that installment payments received in subsequent years by nonresident shareholders under an installment obligation of an S corporation, per IRC § 453 (h) (1) (A), were payments from the sale of stock and were not required to be included or reported by the nonresident shareholders as New York source income.<sup>9</sup>

G. On July 31, 2009 (i.e., after the decision in *Baum* and the determination in *Mintz*), petitioner, a nonresident of New York (and others), sold all of his shares in ESPI to USGI. As was the case with the Luizza sale, petitioner was concerned about his potential exposure to New York tax liability if the parties made the sale a deemed asset sale by electing § 338 (h) (10) treatment. Similarly to Mr. Luizza, and as part of the sale negotiations, petitioner sought the advice of his tax accountant on this issue, to determine whether a higher sale price should be required or an indemnification provision should be included in the terms of the sale.

H. Similarly to Mr. Luizza, petitioner was advised by his tax accountant that there would be no negative New York tax consequences stemming from the election (*see* finding of fact 3). As was the case with Mr. Luizza, petitioner relied upon his tax accountant's advice, and did not require an increased sale price or a tax indemnification provision (*see* finding of fact 4). As noted, the *Baum* decision was issued prior to the July 31, 2009 sale of ESPI, and was specifically relied upon by petitioner for his reporting position regarding his share of the gain from the ESPI

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<sup>9</sup> It is noted that while determinations issued by administrative law judges "shall not be cited" and "shall not be considered as precedent" (*see* Tax Law 2010; *compare* Tax Law 2016), *Matter of Mintz* is referenced by citation herein since that determination was specifically referenced in the Legislature's findings accompanying the 2010 amendments to Tax Law § 632 (a) (2), and was identified by citation in the Court of Appeals' decision in *Matter of Caprio*.

sale, as received in the year of the transaction, and as received thereafter pursuant to the installment agreement payments.<sup>10</sup>

I. In July of 2009, when the subject transaction occurred, Tax Law former § 632 (a) (2) provided as follows:

“In determining New York source income of a nonresident shareholder of an S corporation where the election provided for in subsection (a) of section six hundred sixty of the article is in effect, there shall be included only the portion derived from or connected with New York sources of such shareholder’s pro rata share of items of S corporation income, loss and deduction entering into his federal adjusted gross income, . . . , as such portion shall be determined under regulations of the commissioner consistent with the applicable methods and rules for allocation under article nine-A or thirty-two of this chapter.”

As such, Tax Law former § 632 (a) (2) did not specifically address how a New York nonresident’s gain from the sale of stock in a New York S corporation would be impacted where such sale transaction was treated, pursuant to a valid IRC § 338 (h) (10) election, as a deemed sale of the assets of the S corporation to the buyer, followed by a deemed liquidation of the S corporation in exchange for its stock, notwithstanding that the transaction was carried out (in fact) via the sale of the S corporation’s stock.

J. In 2010, and specifically in response to the results in *Baum* and *Mintz*, the Legislature amended Tax Law § 632 (a) (2), effective August 11, 2010, so as to address the issue of nonresident S corporation shareholders’ treatment of income related to IRC §§ 338 (h) (10) and 453 (h) (1) (A), as follows:

“In determining New York source income of a nonresident shareholder of an S corporation where the election provided for in subsection (a) of section six hundred sixty of this article is in effect, there shall be included only the portion

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<sup>10</sup> As described herein, the sale at issue involved both a § 338 (h) (10) deemed asset sale election, with partial payment in the year of sale (2009), and future installment payments pursuant to promissory notes governed by § 453 (h) (1) (A) (*see* finding of fact 5).

derived from or connected with New York sources of such shareholder's pro rata share of items of S corporation income, loss and deduction entering into his federal adjusted gross income, increased by reductions for taxes described in paragraph two and three of subsection (f) of section thirteen hundred sixty-six of the internal revenue code, as such portion shall be determined under regulations of the commissioner consistent with the applicable methods and rules for allocation under article nine-A or thirty-two of this chapter, *regardless of whether or not such item or reduction is included in entire net income under article nine-A or thirty-two for the tax year. . . . In addition, if the shareholders of the S corporation have made an election under section 338(h)(10) of the Internal Revenue Code, then any gain recognized on the deemed asset sale for federal income tax purposes will be treated as New York source income allocated in a manner consistent with the applicable methods and rules for allocation under article nine-A or thirty-two of this chapter in the year that the shareholder made the section 338(h)(10) election. For purposes of a section 338(h)(10) election, when a nonresident shareholder exchanges his or her S corporation stock as part of the deemed liquidation, any gain or loss recognized shall be treated as the disposition of an intangible asset and will not increase or offset any gain recognized on the deemed asset sale as a result of the section 338(h)(10) election*" (*see* L 2010 ch 57 pt B, § 2) [language added by the amendment in 2010 is italicized]).

The Legislative findings accompanying the adoption of those amendments provided:

"Legislative findings. The Legislature finds that it is necessary to correct a decision of the tax appeals tribunal and a determination of the division of tax appeals that erroneously overturned the longstanding policies of the department of taxation and finance that nonresident subchapter S shareholders who sell their interest in an S corporation pursuant to an election under section 338(h)(10) or section 453(h)(1)(A) of the Internal Revenue Code, respectively, are taxed in accordance with that election and the transaction is treated as an asset sale producing New York source income. Section two of this act is intended to clarify the concept of federal conformity in the personal income tax and is necessary to prevent confusion in the preparation of returns, unintended refunds, and protracted litigation of issues that have been properly administered up to now" (L 2010 ch 57 pt C § 1).

The foregoing amendments to Tax Law § 632 (a) (2) were made applicable "to taxable years beginning on or after January 1, 2007" (L 2010 ch 57 pt C § 4, amending L 2010 ch 312 pt B § 1).

K. On August 31, 2010, the Division issued a memorandum providing public notice and guidance with respect to the foregoing 2010 Amendments (*see* TSB-M-10 [10] I). This memorandum specifically stated that the 2010 Amendments were effective for tax years beginning on or after January 1, 2007, and for any other taxable year in which the period of limitations on assessment remained open. The August 11, 2010 effective date of the 2010 Amendments, and the August 31, 2010 issuance date of the Division's memorandum, predated the October 14, 2010 filing of petitioner's New York state tax return for 2009 (*see* finding of fact 10).

L. The Division initiated audits, and asserted deficiencies, against the taxpayers in *Caprio* and *Luizza*, as well as here, and each protested the same.<sup>11</sup> Each protest centered its due process complaint on the issue of the retroactive application of the 2010 amendments.<sup>12</sup> The Court of Appeals issued its decision in *Caprio* on July 1, 2015 (*see also Burton v New York State Dep't. of Taxation & Fin.*, 25 NY3d 732 [2015]). Thereafter, the Tribunal issued its decision in *Matter of Luizza* on March 29, 2016. Each upheld the retroactive application of the 2010 Amendments to the transactions at issue.

M. The parties agree that the analysis concerning whether the retroactive application of a statute transgresses due process constitutional limits involves a balancing of the equities test, as articulated in *Matter of Replan Dev. v Department of Hous. Preserv. & Dev. of City of N.Y.* (70

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<sup>11</sup> Mr. Caprio did so by commencing a declaratory judgment action seeking a ruling that the Division's asserted deficiency, as applied retroactively to his transaction, constituted a violation of due process. Mr. Luizza and petitioner each filed petitions for administrative review before the Division of Tax Appeals on the same basis, i.e., likewise maintaining that the retroactively asserted deficiencies as applied to their transactions, were in violation of due process protections.

<sup>12</sup> Unlike Mr. Caprio and Mr. Luizza, petitioner has also raised the alternative and independent BAP-based issue concerning whether, assuming the asserted deficiency is upheld against the due process argument, no tax is due in any event since none of ESPI's income was properly allocable to New York.

NY2d 451, 455 [1987], *appeal dismissed* 485 US 950 [1988]). The court in *Caprio*, and the Tribunal in *Luizza*, employed this balancing test, which looks to three factors: (1) “the taxpayer’s forewarning of a change in the legislation and the reasonableness of [the taxpayer’s] reliance on the old law;” (2) “the length of the retroactive period;” and (3) “the public purpose for the retroactive application” (*Matter of Replan Dev.*, 70 NY2d at 456; *see James Sq. Assoc. LP v Mullen*, 21 NY3d 233, 246 [2013]).

N. In light of the decisions in *Caprio*, *Burton*, and *Luizza*, it is now settled law that the 2010 amendments to Tax Law § 632 (a) (2) may be applied retroactively to tax years beginning on or after 2007, without violating the Due Process Clauses of the United States and New York State Constitutions. It is likewise now well settled that the interpretation and application of Tax Law § former 632 [a] [2]), specifically in circumstances involving IRC § 338 (h) (10) and/or IRC § 453 (h) (1) (A), prior to the 2010 amendments, as espoused by Mr. Caprio, Mr. Luizza and petitioner were incorrect (*see id.*).<sup>13</sup> Consequently, the manner in which petitioner’s 2009 tax return was filed, in October of 2010, was likewise incorrect. Petitioner does not contest this fact, or contest the facial validity of the retroactivity of the 2010 amendments. However, petitioner does contest the retroactive application of the 2010 amendments to his particular circumstances, maintaining that such application results in an “as applied” violation of his due process rights. Petitioner points out that his transaction, unlike the transactions in *Caprio* and *Luizza*, took place after and in reliance on, the Tribunal’s decision in *Baum*. Accordingly, petitioner argues

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<sup>13</sup> As the Tribunal pointed out in *Luizza*, a reading of *Caprio* and *Burton* shows that the Court of Appeals upheld the retroactivity of the 2010 amendments as to both the deemed asset sale amendments and the installment obligation amendments, without differentiation in analysis or ultimate result (*see Matter of Luizza* at 19 through 21 [Court of Appeals explained that plaintiffs in *Caprio* utilized IRC § 338 (h) (10) and were subject to IRC § 453 (h) (1) (A) in their transaction, and made clear its intention to uphold the retroactivity of the entirety of the 2010 amendments, including the deemed asset sale amendments as well as the installment obligation amendments]). Accordingly, references to the deemed sale amendments shall include the treatment of the installment obligations that are part of the transaction at issue.

that this resulting extra level of reliance exceeds the parties' stipulated reliance in *Luizza*, tips the scale in his favor, and requires a conclusion that the deficiency at issue represents an unconstitutional application of the 2010 amendments.

O. Accepting petitioner's argument requires ignoring the *Caprio* Court's recognition and acceptance, based on the Legislature's findings in support, that the 2010 amendments served to clarify and confirm the Division's longstanding correct interpretation, application and administration of existing law, whereby gains from a deemed asset sale under IRC § 338 (h) (10) are not excluded from nonresident's New York source income as gains from the disposition of intangible assets, but rather are included to the extent of the S corporation's New York BAP. Thereafter, in *Luizza*, the Tribunal initially identified the issue presented as "[W]hether the [Division's] retroactive application of amendments to Tax Law § 632 (a) (2), which were enacted in 2010, to a transaction that was negotiated and completed between 2007 and 2008, is unconstitutional under the Due Process Clauses of the United States and New York Constitutions" (*Matter of Luizza*). The Tribunal subsequently further clarified the issue as "whether this Tribunal must hold that the retroactive application of the 2010 amendments as applied to [the Luizzas] is constitutional based on the Court of Appeals decision in *Caprio*, or whether petitioners have been able to sufficiently distinguish the facts and circumstances herein so as to support a finding that the retroactive application of the 2010 amendments as applied to petitioners constitutes a violation of the Due Process Clauses of the United States and New York Constitutions" (*Id.*). In *Luizza*, the Tribunal explained that notwithstanding the fact that the 2010 amendments were upheld in *Caprio*, petitioners "were still entitled to prove that their case can be distinguished from *Caprio*, based upon differences in the the facts and circumstances in each case" (*see Matter of Luizza*).

P. The petitioner in *Luizza* sought to distinguish his transaction from *Caprio*, based upon differences in the facts and circumstances in each case. As noted, the Tribunal recognized the right to do so, but also explained that “the broad reach of the language in *Caprio* leaves little room for factually distinguishing their case” (*Matter of Luizza*). The Tribunal then held, upon its analysis of the three factor test concerning whether retroactive application of a tax statute violates due process standards, that the broad reach of the language in *Caprio*, upholding the retroactivity of the entirety of the 2010 amendments, controls and that the facts and circumstances present in *Luizza*, including specifically the parties’ stipulation that Mr. Luizza reasonably relied upon his accountant’s advice and had no forewarning of a change in the relevant law, were insufficient to distinguish it from the Court of Appeals holding in *Caprio* (*see Matter of Luizza*). Here, the relevant facts are essentially identical to those in *Luizza*, excepting only the additional fact that the Tribunal’s decision in *Baum* had been issued prior to the July 1, 2009 consummation of the ESPI to USGI transaction. Thus, that same three factor analysis must include petitioner’s reliance upon the Tribunal’s decision in *Baum*, and the essential question is whether that one additional fact is sufficient, as petitioner claims, to require a different result.

Q. Petitioner maintains that his entire course of conduct in this case must be evaluated as of the date of the ESPI to USGI sale. However, such evaluation cannot simply be made in a vacuum. In fact, two different points in time are relevant with regard to this matter. The first relates to petitioner’s reliance on his tax accountant’s advice concerning the tax impact of a § 338 (h) (10) election. As petitioner correctly points out, for purposes of determining whether a due process violation occurred, petitioner’s reliance must be evaluated as of the date of sale, since that is the point in time at which petitioner ultimately gave up the right to require either a higher purchase price or indemnity against New York taxation if his position regarding non-taxability

did not prevail. The second concerns the reporting position taken by petitioner at the time of the filing of his 2009 return, as well as his subsequent non-filing for 2010 and 2011. While his filing position (eliminating his gain on the sale in 2009, with no filings reporting gain for later years) is consistent with his initial position (at the time of sale) that no New York tax was due on the transaction, that filing position was taken in 2010, and was subsequent to the 2010 amendments to Tax Law § 632 (a) (2), and to the Division's issuance of its public memorandum with respect thereto (*see* findings of fact 8 and 9). As such, this filing position was clearly inconsistent with the law as it existed at the time of petitioner's filing for 2009, and thereafter.

R. As explained above, the Legislature enacted the 2010 amendments to:

a) clarify and ratify the Division's longstanding interpretation and application of Tax Law § 632 (a) (2) that proceeds received in circumstances involving an IRC §338 (h) (10) election, or a transaction subject to IRC §453 (h) (1), resulted from deemed asset sales, or the receipt of payments consequent thereto, respectively, such that nonresidents were required to report their share of such proceeds as New York source income and,

b) to correct the decision in *Baum* and the determination in *Mintz* that erroneously overturned the foregoing longstanding policies of the Division (*see* conclusion of law J).

At the time of enacting the 2010 Amendments, the Legislature was thus clearly aware of the *Baum* decision and the *Mintz* determination, and of the consequences resulting therefrom. In turn, the Court in *Caprio* specifically recognized that such amendments were enacted as necessary in order to cure the incorrect decisions reached in the *Baum* and *Mintz* matters, to clarify the concept of federal conformity, to avoid taxpayer confusion in preparing returns, to avoid complex and protracted litigation, and to prevent unwarranted refunds so as to stem the loss of revenue that would result from such incorrect decisions (*see id.*).

By making the 2010 Amendments retroactive, the Legislature evinced both its clarifying and corrective aims. In doing so, it drew no distinction between transactions that predated the Tribunal's decision in *Baum*, such as was the case in *Luizza*, or postdated such decision, notwithstanding that some taxpayers could claim, as is the case in this matter, to have relied on *Baum*. The Legislature did not limit the retroactive reach of the 2010 Amendments by any reference to the *Baum* decision, but rather extended retroactivity to all open years upon the foregoing clarifying and correcting justification bases. Thus, the Legislature's intended sweep of retroactivity included those who could have, and as is made evident by this case, in fact did rely on *Baum*. The final judgment of the Court in *Caprio* approved such full retroactivity (*Matter of Caprio* at 755 [the retroactive application as to plaintiffs of the 2010 amendments to Tax Law § 632 (a) (2) is valid under the Due Process Clauses of the United States and New York Constitutions]).

S. As noted earlier, each of the facts that were presented as bases to distinguish *Luizza* from the holding in *Caprio* are present in this case. In addition, petitioner points out that his transaction occurred after the Tribunal issued its decision in *Baum*, and argues that his reliance on *Baum* provides an additional, and obvious, differentiating strength sufficient to support a conclusion that retroactively applying the 2010 amendments here violates petitioner's due process rights. Given the Court's holding in *Caprio*, as explained in *Luizza*, however, the additional factual distinction of petitioner's reliance on *Baum* is insufficient to find a due process violation. In this regard, and notwithstanding its recognition and acceptance that the petitioner in *Luizza*, as stipulated, relied upon his tax advisors' interpretation of prior law to his detriment, the Tribunal nonetheless held as follows:

“However, *Caprio* still requires us to conclude that petitioner’s reliance on the law cannot be held to be reasonable despite the stipulation signed by both parties and the additional facts petitioners have proven. This is because, according to *Caprio*, petitioner should have been aware, at the time he negotiated and concluded the sale of the Company, of the long standing policies of the Division. In particular, the Court of Appeals in *Caprio* found that: “Acceptance of plaintiffs’ interpretation of the pre-amendment law would require that we discredit the legislative finding articulated in the amended statute that long-standing policies of DTF required taxpayers to pay proportionate state income taxes on deemed asset sale gains” (*Caprio*, 25 NY3d at 754). The court went on to conclude that it would “give due consideration” to the Legislative findings, particularly in light of the Division’s additional evidence of its long-standing policy, “an unrefuted affidavit of a DTF tax auditor detailing this State’s taxation policy” (*Caprio*, 117 NY3d at 755). Petitioners argue that the Division in this case submitted no evidence concerning any long-standing policy it had regarding its treatment of IRC § 338 (h) (10) elections as they relate to nonresident S corporation shareholders. *However, we read Caprio as holding that the Legislative findings alone require a conclusion that the Division’s long-standing policy differed from petitioner’s interpretation of the law, making petitioner’s reliance on his interpretation unreasonable and defeating petitioners’ argument that petitioner had no way of foreseeing the change made by the 2010 amendments” (see Matter of Luizza, emphasis, including bold, added).*

Clearly, the foregoing holding includes rejection of the Tribunal’s own prior view of pre-amendment Tax Law § 632 (a) (2), as set forth in *Baum*.<sup>14</sup>

T. Ultimately, accepting petitioner’s claim requires ignoring the fact that the Court in *Caprio* was specifically aware of the Tribunal’s decision in *Baum*, and at least implicitly understood that in light of the full period of retroactivity imposed by the 2010 amendments, taxpayers like petitioner might rely to their detriment on *Baum* for their filing position. Nonetheless, the Court still upheld the full period of retroactivity on the strength of the Legislature’s findings in support. As to petitioner’s specific reliance on *Baum*, the Tribunal’s final paragraph in *Luizza* is instructive, in stating the following:

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<sup>14</sup> It is worth noting that nothing in the findings of fact in *Baum*, or in the Tribunal’s conclusions of law based thereon, indicate that the Tribunal was made aware, at the time that decision was issued, of the Division’s longstanding and correct policies in interpreting, applying and administering Tax Law § 632 (a) (2) in circumstances involving elections under IRC §§ 338 (h) (10) and 453 (h) (1) (A). Such longstanding policies “that required taxpayers to pay proportionate state income taxes on deemed asset sale gains,” as stated in the Legislative findings, were crucial to the Court of Appeals in arriving at its decision in *Caprio*, and in turn to the Tribunal in arriving at its decision in *Luizza*.

“Obviously, the Legislature can override any decision of this Tribunal prospectively, as it can with any decision of the courts of this state. The issue is whether it can retroactively correct a final decision of this Tribunal. While we do not know whether any arguments regarding the finality of Tribunal decisions were before the Court of Appeals in *Caprio*, we do know that throughout the decision, reference is made to the legislative findings regarding *Matter of Baum* and the retroactive application of the deemed asset sale amendments. Furthermore, the conclusion reached is that ‘the curative, rational public purposes set forth in the legislative findings are compelling and, thus, this factor also supports upholding the retroactive application of the statute’ (*Caprio*, 20 NY3d at 758 [citations omitted]). *There is no indication in this conclusion, and every indication to the contrary in the Caprio decision, that the deemed sale amendments adopted by the Legislature in response to this Tribunal’s final decision in Matter of Baum, were meant to be excluded from this conclusion*” (*Matter of Luizza* [emphasis added]).

In sum, the analysis and result regarding the first *Replan* factor (i.e., “the taxpayer’s forewarning of a change in the legislation and the reasonableness of [his] reliance on old law”) is driven by *Caprio* and *Luizza*. Notwithstanding the fact that petitioner, like Mr. Luizza, relied to his detriment, as described, and that such reliance was in fact stronger in light of the Tribunal’s decision in *Baum*, such reliance was not reasonable (*id*; *see also* conclusion of law S, n 14).

U. The other two *Replan* factors to be considered in the issue of retroactive applicability of a legislative amendment are the period of retroactivity and the public purposes supporting such retroactivity, each of which was thoroughly discussed in *Caprio* and in *Luizza*. Even assuming that petitioner could establish that he met the first prong of the three-pronged balancing test, it remains that he has not met the other two prongs (“length of retroactive period” and “the public purpose for the retroactive application”), and therefore cannot prevail herein (*Matter of Replan Dev.*, 70 NY2d at 456; *Matter of James Sq. Assoc.*, 21 NY2d at 246). As is particularly relevant, the Court of Appeals accepted the validity of the Legislature’s stated aims of curing an incorrect Tribunal decision in order to prevent the consequences of such decision. As noted, the Court accepted that the decision in *Baum* was a departure from the Division’s long-standing and

articulated policy in administering transactions involving deemed asset sale elections made by nonresident taxpayers. The *Caprio* Court’s decision reflects the conclusion that there was a legitimate public interest in curing the consequences resulting therefrom, including avoiding confusion in filing, unintended refunds, and protracted litigation. While petitioner maintains that the revenue loss likely from the allegedly small number of taxpayers who fall within the time frame described here is comparatively minimal, the Legislature carved out no exception in this regard. That is, the amount of revenue loss was not quantified, or limited to any specified period, but rather concerned the overall loss of revenue anticipated by rejecting the manner in which transactions such as the present had been previously administered by the Division. Thus, the validity of the Legislature’s loss of revenue justification is not diminished by the relative significance of the quantity of revenue loss in any individual case, or more generally in light of pre-*Baum* or post-*Baum* cases. In fact, and unlike certain 2010 Amendments addressed in *James Square*, in which the public policy justifications for retroactivity were rejected by the Court of Appeals, the 2010 Amendments at issue here did not serve to increase revenues via the effective enactment of a new tax, or by the after-the-fact imposition of new requirements to the qualifications for receiving an existing tax benefit at a point in time when a taxpayer could not adjust its previously taken course of conduct. It cannot be said, in light of the Court’s decision in *Caprio*, that the 2010 Amendments attached “new legal consequences to events completed before its enactment” (*Id.*, see also *Landgraf v USI Film Prod.*, 511 US 244, 290 [1994]; compare *Matter of Hale*, Tax Appeals Tribunal, June 14, 2018). The Legislature’s action represented its approval of the imposition of an existing liability, consistent with the manner in which such imposition of liability had been applied under the Division’s longstanding view and interpretation of the relevant statute. In *Caprio*, the Court concluded that *Baum* and *Mintz* upset

settled law, and the amendments were enacted, in part, to stop the loss of expected revenues under settled law by unintended refunds (or, as here, by the issuance of deficiency notices for all open years), as opposed to gaining “new” revenue via retroactive application of such amendments.<sup>15</sup>

V. In sum, the imposition of the tax at issue is not an unconstitutional application of the law in violation of constitutional due process standards. Accordingly, petitioner’s challenge on due process grounds must fail.

### ***Apportionment and BAP***

W. In light of the foregoing conclusion, it is necessary to address petitioner’s alternative BAP, argument. Despite petitioner’s argument that ESPI merely facilitated transactions between suppliers, deliverers and consumers of electricity, it remains that ESPI’s receipts resulted from its ongoing purchases and sales of electricity, with ESPI’s profitability dependent upon its ability to obtain and provide electricity to its customers at a comparatively more attractive price than the prices offered by other suppliers, including other ESCOs or public utilities. The portion of ESPI’s receipts that were profit to ESPI were derived from its use of available incentives and benefits in its calculation of the “blended” price at which, together with transactional fees, it sold electricity to its customers. Thus, the profit opportunity, or “available niche,” recognized by ESPI derived from its price for electricity, and the core aim of its business was to sign up customers to whom it could sell electricity at a profit.

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<sup>15</sup> In light of the 2010 Amendments, and the combined rationales of *Caprio*, *Burton* and *Luizza* (and notwithstanding the reasoning and result set forth in the *Baum* decision and *Mintz* determination), there was never in fact a point in time when the “benefit” of non-taxability with respect to transactions like the one at issue here was available or at stake, such that the abrogation thereof could be said to constitute a due process violation.

X. Petitioner claims, upon the testimony of Mr. Cahill, that ESPI did not provide any tangible personal property or electricity to its customers, but rather simply facilitated transactions and consulted with customers concerning utility providers. Thus, petitioner maintains that its receipts should properly be considered “receipts from services,” per Tax Law § 210 (3) (a) (2) (B), or “other business receipts,” per Tax Law § 210 (3) (a) (2) (D). Petitioner asserts that under either of such circumstances, its receipts were not properly self-apportioned to New York, but should have been apportioned elsewhere (presumably to Massachusetts), based upon where the services generating such receipts were performed. In fact, providing electricity to its customers is what ESPI did, via its purchases of electricity from NYISO and its subsequent sale of that electricity to its customers. Petitioner’s position that it was merely a transaction facilitator overlooks, and is in fact belied by, the energy purchase contracts between ESPI and NYISO that are in the record, by the consistent written descriptions of ESPI and its business (*see* finding of fact 24), by the testimony at hearing, and by ESPI’s consistent 100% self-apportionment of receipts to New York, coupled with its failure to have apportioned any of its receipts to Massachusetts or elsewhere (*see* finding of fact 25). In sum, ESPI was paid for the electricity it sold to its customers, and was, in fact, an electrical energy supplier. While ESPI contacted consumers with the acquiescence of the public utilities, alerted such consumers to the existence of potential energy cost savings, and facilitated the process by which such consumers could gain the benefit of such costs savings, it remains that such consumers became ESPI’s customers who paid ESPI for the electricity it sold to them.

Y. Notwithstanding that its customers were contacted from outside of New York, ESPI was paid for the electricity it purchased from NYISO and sold to its customers in New York, and the receipts from such sales in New York are properly apportioned to New York. The facts that

the electricity purchased and sold by ESPI to those customers with whom it contracted was delivered via a separate and different entity (e.g., a public utility such as National Grid or Orange and Rockland Gas and Electric), and that the delivery entity collected ESPI's receipts for its electricity sales, under the "one bill" system, does not somehow mean the electricity was sold to the delivery entity by ESPI, as a component part of its delivery obligation (for which the delivery entity was separately compensated).<sup>16</sup>

Z. It is not inaccurate, per se, to state that ESPI provided information and facilitated the transactions by which former utility customers became ESPI customers. However, and notwithstanding the Cahill testimony, it is clear that ESPI's receipts were derived from its ongoing and repeated sales of electricity to its customers, and not simply from identifying and advising consumers of potential energy cost savings opportunities, or simply from facilitating the receipt of such benefits by consumers. Additionally, the fact that ESPI never "physically possessed" the electricity it purchased and sold, but rather that the transactions were "all accomplished by meters and computers," is of no moment and is, essentially, sophistic in nature. In fact, ESPI's receipts were derived from the sale of a good or commodity (*see Matter of Clark*, Tax Appeals Tribunal, September 14, 1992; *Matter of BT Capital*, Tax Appeals Tribunal October 1, 1992 [electricity has the tangibility required to be a good]), and such receipts are

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<sup>16</sup> In its brief, the Division notes testimony by Mr. Cahill that ESPI employees had IDs provided by at least one of the utilities (Orange and Rockland Gas and Electric) authorizing ESPI to contact customers. The Division maintains that the need for such IDs suggests the ESPI's employees may have been physically present in New York, notwithstanding Mr. Cahill's testimony that all customer contact by ESPI employees occurred by telephone and/or computer from ESPI's call center in Pittsfield, Massachusetts. While it is possible that ESPI's employees could have been present in New York, and therefore needed IDs for purposes of solicitation of customers (under local or other laws or ordinances), it is also equally possible that Mr. Cahill's ID reference concerned a means by which an ESPI employee could provide proof of bona fides to a potential customer contacted by telephone. Given the overall testimony, including the affirmative statements that all contact was by telephone and/or computer from the out-of-state located call center, and the lack of any additional testimony or other countervailing evidence or indication that ESPI employees were, or had any apparent need to be, physically present in New York, the Division's suggestion that ESPI employees were physically present in New York for any purposes connected with ESPI's business is discounted as not supported by the record.

properly apportionable to New York (Tax Law § 210 [3] [a] [2] [A]). Petitioner's circumstances are no different from those where a middleman purchases a good or commodity and arranges for delivery to its customer, where the quantity of the good or commodity sold is measured and determined by metering and where the receivable is generated by computer computation rather than by hand (e.g., the purchase and sale of natural gas with delivery by a third party pipeline or, for that matter, by a third party tanker truck). Assuming ESPI's receipts are "other business receipts," per Tax Law §210 (3) (a) (2) (D), to be sourced where earned, the same were clearly earned upon the sale of electricity to ESPI's customers in New York. Again, it is noted that ESPI historically reported all of its receipts as New York receipts, via the 100% receipts factor used in calculating its BAP, and did not apportion or report any of its receipts as Massachusetts receipts. In sum, ESPI's receipts may not fairly be characterized as derived from services, but rather were derived from the sale of goods to customers mainly located in New York, and it is simply inapposite to accept that ESPI was paid on an ongoing basis, by the same customers, for consulting and facilitating energy transactions.<sup>17</sup> Properly viewed, ESPI developed a business whereby it purchased and sold electricity at a price from which it could generate a profit, by the use of available incentives and benefits. ESPI supplied electricity at a price lower than other suppliers, including those public utilities who willingly provided their customer lists to ESPI.

AA. In his brief, petitioner makes reference to more recent interpretations concerning apportionment of receipts derived entirely from performing services. The Division concedes, in its brief, that if ESPI was only providing a service, then its receipts could appropriately be

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<sup>17</sup> Petitioner's BAP argument might be more persuasive if ESPI had been engaged in the business of contacting consumers on behalf of other ESCOs to advise such consumers of the availability of price-lowering incentives and benefits in an effort to sign up such consumers as customers for other ESCOs, and received its receipts for such activities, as opposed to engaging in the business of contacting consumers, as it did, for the primary purpose of engaging such consumers as ESPI's own customers to whom ESPI would sell electricity at its price.

sourced to the locale where such service was performed. Such more recent interpretations, involving the electronic facilitation of travel reservations, and the facilitation of electronic movement of funds, respectively, are clearly distinguishable from the circumstances presented in this case. Each concerns strictly the provision of services, with no taking of ownership or subsequent selling of anything. ESPI, in clear contrast, purchased electricity from NYISO, and sold the same to its customers in New York, with delivery via transmission by the relevant public utility for a separate charge. Again, ESPI was not simply a service provider, but was its customers' electricity supplier.

BB. Finally, petitioner seeks abatement of the penalties imposed by the Division under Tax Law § 685 (a) (1) for his failure to have filed returns for the years 2010 and 2011. First, as thoroughly discussed in both *Caprio*, and subsequently in *Luizza*, the 2010 Amendments to Tax Law § 632 (a) (2) were enacted to clarify the law applicable to the specific type of transaction at issue herein, and to cure the erroneous decision in *Baum* and determination in *Mintz* as representing departures from the Division's long-standing and correct interpretation and administration of the law. It is noteworthy that such amendments were enacted on August 11, 2010, and thus predated the October 14, 2010 filing date of petitioner's tax return for the year 2009. In addition, the Division's August 31, 2010 issuance of explanatory guidance regarding the 2010 Amendments likewise predated such filing date. Furthermore, all of the returns relevant to this matter were prepared by the accounting firm by whom petitioner's tax accountant was then employed, and upon whose advice petitioner relied with regard to the tax implications of the elections made in connection with the sale of ESPI. Petitioner's tax accountant admitted to reviewing all of such returns before they were filed (*see* finding of fact 7). It is at least curious, given the attention devoted to determining the potential New York tax impact of the sale of

ESPI, in light of the IRC § 338 (h) (10) election (*see* finding of fact 3), why the specific question on ESPI's short period form asking whether an IRC § 338 (h) (10) election, or an IRC § 453 (h) (1) election, had been made, was answered in the negative (*see* finding of fact 7). The parties did not address this manner of filing, and it could be that the same was simply an inadvertent error. However, it is at least equally likely that such manner of filing was deliberate. Filing in this manner not only fails to disclose such elections, but more importantly, directly contradicts the fact that such elections were made. The unspoken, though rather obvious, implication would be that such manner of filing may have been affirmatively chosen to avoid drawing attention to such elections in an effort to avoid the initiation of an audit review of the sale transaction, of ESPI's final (short period) return, and the impact on petitioner's filings for 2009 and thereafter. At a minimum, this manner of filing speaks not only to the issue of full disclosure, but also raises a question regarding the credibility of the testimony alleging petitioner's complete and reasonable reliance on the decision in *Baum*, and of being unaware of any changes to the law subsequent thereto (*see* finding of fact 12; *see also Matter of Varzar*, Tax Appeals Tribunal, April 2, 2015; *Matter of Campaniello*, Tax Appeals Tribunal, July 21, 2016 [inconsistent manner of filing impacts credibility of testimonial claims related thereto]). In sum, the credibility of petitioner's, and his tax advisor's, testimonial claim that they were unaware (or do not remember becoming aware) of any changes after *Baum*, is difficult to fully credit, in light of the manner in which ESPI's S corporation short period return was filed (*id.*).<sup>18</sup> Given that the 2010 amendments were enacted and effective prior to petitioner's filing for 2009, and that public guidance had been

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<sup>18</sup> Even assuming the truth of petitioner's claim that he, and his tax advisor, were unaware of the 2010 amendments and of the Division's public guidance issued with respect thereto, it is a long-standing principle that ignorance of the law as to the manner of one's filing, or with regard to one's failure to file, is not an excuse for such failures.

issued thereon, petitioner was under an obligation to file in a manner that reported his gain from the ESPI sale transaction as New York source income in 2009, and to report the installment amounts received in 2010 and 2011 in the same manner, and thereafter file a claim for refund based on the position espoused herein. All of the foregoing factors weaken the claim that petitioner was under no obligation to file or report for the years 2010 and 2011, and taken together, support the Division's imposition of penalties for nonfiling for those years. Accordingly, such penalties are sustained.

CC. The petition of Franklin C. Lewis is hereby denied, and the notice of deficiency dated May 30, 2013 is sustained.

DATED: Albany, New York  
June 20, 2019

/s/ Dennis M. Galliher  
ADMINISTRATIVE LAW JUDGE